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On EM Monetary And Fiscal Policy…And The Importance Of Central Bank Independence

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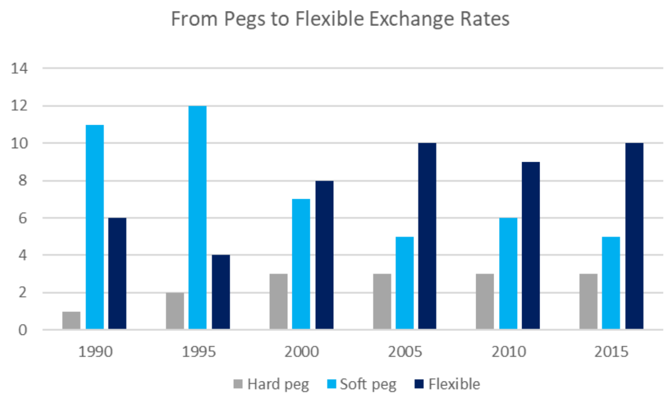
- Mexico's currency sold off recently on the back of Lopez Obrador's move to pull former Finance Minister Arturo Herrera's nomination for central bank governor. Back in June, the President has announced that Herrera would take over the central bank in 2022. That nomination was then withdrawn in August. A week ago Herrera was told his nomination would be reconsidered, but the latest headlines are that, again, the nomination has been pulled and that Victoria Rodriguez, finance undersecretary, will now be nominated. Current governor Alejandro Diaz de Leon will leave his post on 31 December 2021.

- Why is this causing anxiety and why is it important for investors who the central bank head is? The purpose of this note is to address this broader issue rather than the specifics of the Mexican case. This is a topic we consider critical to understanding current fundamental underpinnings of emerging market (EM) economies and their possible vulnerabilities and could give us some insight to identify and quantify potential risks and opportunities.

- Let's start with some basic ideas:
  - A modern economy cannot function effectively without a stable monetary framework. This means that a country's currency has to function as money in the sense that it has to be a reserve of value, unit of measurement and universally accepted within that economy. Some countries have currencies, but they don't function as money in its complete definition -Argentina and Venezuela are examples of this.
  - Economies that choose to have their own currency (most of them) need a central bank (CB) to manage the supply of money in a sensible manner. These CBs have to have a credible reaction function to shocks, be them from domestic supply/demand related to the economic cycle or external shocks such as commodity prices or foreign capital availability. Economic agents and market participants have to be able to reliably count on CBs to follow their established mandate of monetary stability in order to make consumption and investment decisions.
  - In order to do their job, central banks have to be independent from public accounts, government budgetary constraints and political pressures. Despite what many politicians think, financing public deficits is not the role of a CB. Their role is to properly match the physical side of the economy (production) with money supply (amount of money in circulation) and in turn provide stability and predictability to the value of the currency.
  - We can broadly group EM central banks and economies into two categories: 1. those where governments "got it" and decided to give their CBs independence, for example Russia, Mexico, Brazil, Chile, Peru, Colombia) and 2. those that "didn't get" such as Turkey, Argentina and Venezuela.

- The first group runs free floating exchange rate frameworks with money supply adjusted via an inflation targeting regime which sets the level of short-term interest rates. In other words, they control money supply but not the level of the exchange rate. This allows market participants to price their expectations throughout the full-term structure of interest rates generating useful pricing signals to the economy. These frameworks are similar to the Federal Reserve and European Central Bank's, but minus the Quantitative Easing -which is effectively temporary deficit monetization and which is only viable given the reserve status of their currencies, the USD and EUR.
- The second group has monetary frameworks that, even when directed by the right mandate, attempt to control both price and quantity of money -and in some cases also the level of the exchange-, something that is not possible, or at least not sustainable without generating large imbalances. These frameworks eventually translate into high inflation (sometimes hyperinflation), collapse of demand for domestic currency, capital outflows and balance of payments and credit crisis.

Figure 1: The largest EM economies have transitioned to flexible or free-floating exchange rates over the past 20yrs with central banks setting interest rates based on explicit inflation targets. Over the years, particularly since the early 2000s, the consistency of their actions has allowed for the setting of long-term local rate curves.



Source: IMF as of April 2019
Currency Peg: when a country maintains its currency value at a fixed exchnge rate to another currency

Figure 2: Today the majority of the large economies in EM have adopted monetary and currency frameworks similar to those of developed markets. This has reduced inflation and incentivized the formation of larger pools of domestic saving and investment. Those countries that maintained unorthodox policies have seen inflation expectations become un-anchored.

	Exchange rate regime	Central Bank Regime
Argentina	Crawling Peg	Monetary Aggregate since 2018
Brazil	Free float	Inflation targeting since 1999
Chile	Free float	Inflation targeting since 1999
Colombia	Free float	Inflation targeting since 1999
Mexico	Free float	Inflation targeting since 2001
Peru	Free float	Inflation targeting since 2002
Russia	Free float	Inflation targeting since 2014
Turkey	Dirty float	Inflation targeting since 2012

Source: Bloomberg as of 22 November 2021

Average Period YoY Inflation	Argentina	Turkey	Mexico	Brazil	Russia
1990-1999	4%	77%	20%	848%	222%
2000-2020	26%	16%	5%	6%	10%

Source: Bloomberg 22 November 2021

- Consistent and credible monetary frameworks are critical to the proper function of an economy. It follows that the people managing the CBs play a very important role. But a properly functioning CB is a necessary but not sufficient condition.

- Responsible fiscal policy comes into play as an additional condition for long term stability and growth and it is here where political views and actions present the highest potential risk. Public accounts require management between tax collection and income with spending and investment. Deficits can be financed via domestic or external borrowing and or an inflation tax. It is on this later means of financing that the CBs play their role. If monetary supply exceeds demand for transactions, there is inflation. Inflation is a form of currency debasement, a form of defaulting by CB on their mandate of maintaining the monetary -purchasing- value of the currency. But inflation is also a useful policy incentive for economic agents to save, invest and transact and so some level of low predictable inflation is universally agreed as a desirable feature in an economy. Hence the very widely adopted inflation targeting model of many CBs around the world.

- Risks to economic stability appears with high inflation uncertainty. CBs that act erratically or provide excessive public deficit financing under pressure from political actors lose credibility. The loss of credibility in their mandates is typically followed by a drop in demand for the local currency causing it to depreciate relative to the rest of the world, capital flight, higher financing costs and risk premiums and eventually lower consumption and investment. This dynamic has a negative impact on growth and triggers a potentially negative vicious cycle of fundamental macroeconomic deterioration.

- Many Latin American economies are finding themselves closer to this crossroad where political change could result in important policy changes. Fears that administrations on the extremes of the political spectrum de-rail years of monetary stability to finance ever growing social demands are causing investors to demand high risk premiums from Latin American markets.

- What we believe is currently happening in the region is that social pressures resulting from years of lack of growth combined with increasing income and wealth gaps are generating sharp polarizations in voter preferences towards the far right and far left ends of the political spectrum. This higher uncertainty has translated into equity market and currency weakness that would typically not occur given current favorable external conditions presented by high commodity prices, terms-of-trade, earnings recovery and level of economic activity. In other words, we believe current Latam market weakness has a very high degree of political risk embedded and it is this political risk that is feared could translate into policy changes that could further weaken fiscal accounts which in turn might turn to be financed by CB monetary supply. All in all, we consider the balance of risks of such a sequence of events as lower than what markets are currently pricing in. Having said that, election results, compositions in congress and policy rhetoric bear close scrutiny in the coming months.

Figure 3: Latam economies are expected to rebound close to 7% in 2021. Corporate earnings are expected to grow over 200% to EPS levels not seen since 2012. Global monetary conditions remain lose. Commodity prices are high.

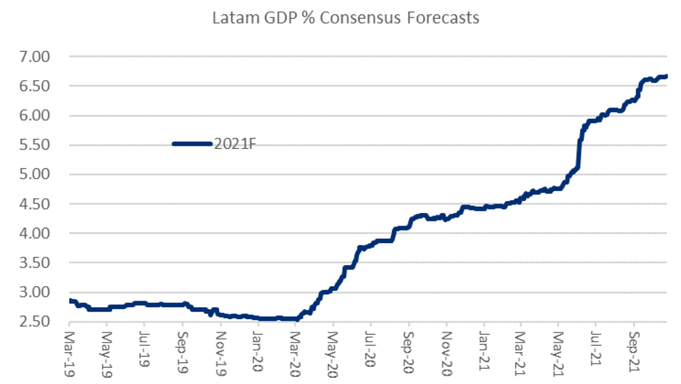
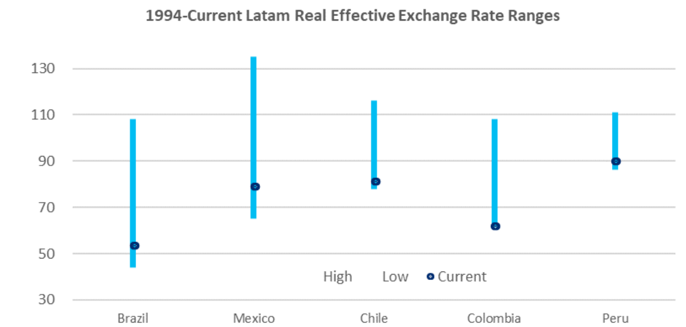


Figure 4: Yet currencies remain at historically depressed levels, pressured by political uncertainty and concerns over policy shifts.



Source: Bloomberg as of 22 November, 2021

All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

- Turkey is a good example of what happens when CB credibility is lost. The Central Bank of Turkey (CBT) has an explicit inflation targeting regime since 2012. However, for some time, President Erdogan, in an attempt to ease financial conditions and stimulate growth, has pressured the entity to cut interest rates in the face of rising inflationary pressures. Since 2019 Erdogan has removed three CBT governors for not falling in line with the interests of the executive. The result has been a loss of confidence in the monetary authority and the loss of over half the value of the Turkish Lira (TRY) against the USD.

Figure 5: Even though inflation expectations continue to rise, the CBT has not only fallen behind, but have acted contrary to their inflation targeting mandate. This is resulting in a loss of credibility in the entity.

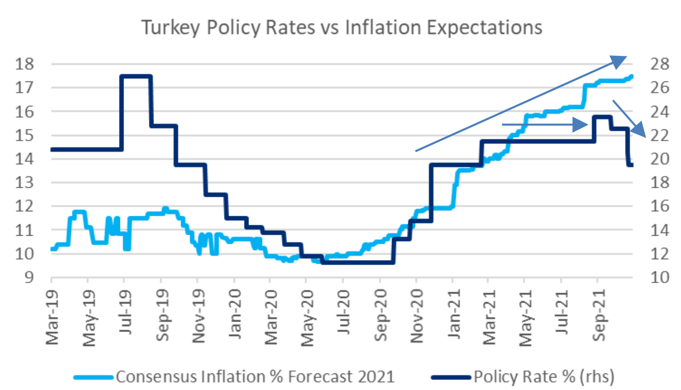
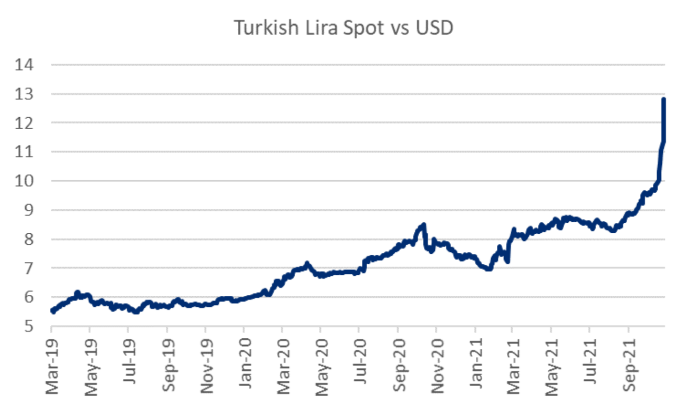


Figure 6: The TRY has depreciated over 100% relative to the USD since 2019 when President Erdogan began sacking CBT governors for not having a more dovish stance. The depreciation of the TRY has accelerated as inflation expectations continue to rise and the CBT fails to raise rates as per their mandate.



Source: Bloomberg as of 22 November, 2021

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- The Central Bank of Brazil's (BACEN) behavior and resulting credibility presents a stark contrast to Turkey's. The entity has been tested repeatedly over the last two decades and has consistently acted with a highly predictable reaction function under various crisis. The most recent actions by BACEN have only had a marginal impact on the Brazilian Real (BRL). The economy is showing a strong pace of recovery, corporate earnings are rising, commodity prices remain high, and terms of trade are favorable, but the currency and its financial markets have been unable to recover. We believe the reason is that investors have been concerned with the fiscal dynamics and potential slippage of the deficit into inflation expectations, with the subsequent need for the CB to continue to increase rates putting pressure on growth. As we have written here, however, we are of the view that fiscal anchors in Brazil could be stronger than what markets are discounting.

Figure 7: BACEN has acted in lockstep with the rise in inflation expectations, raising rates despite the contractionary impact on the economy. 2021 inflation expectations have risen to above 10% with BACEN expected to hike rates to around 11% in the coming months. Local markets are already pricing this in with long dated bond trading near 12%. Inflation for 2022 is forecasted to fall but investors forecast policy rates to remain elevated.

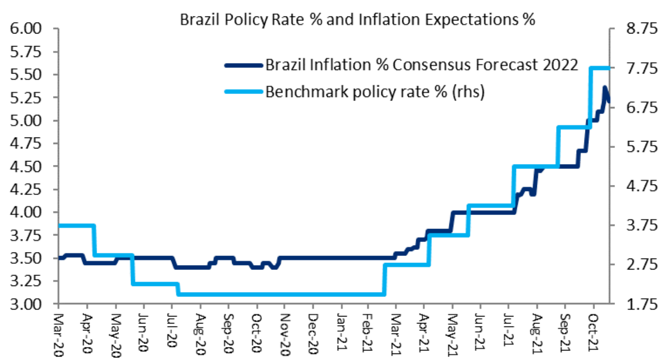
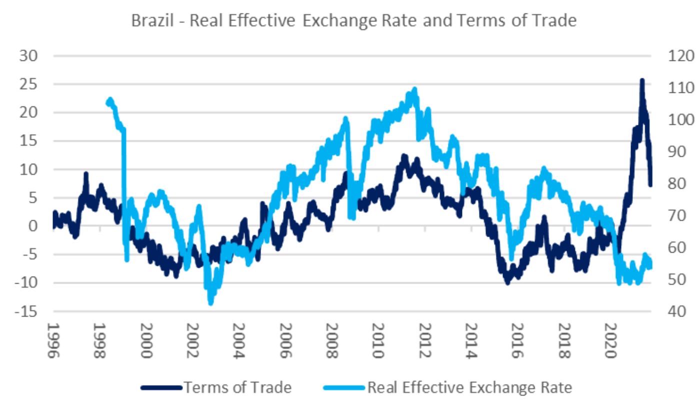


Figure 8: BRL weakness is difficult to explain on current fundamentals. More likely is that investors are pricing in large discounts to Brazilian assets on the fear that fiscal discipline be relaxed materially with potential future consequences for monetary policy stability. Our view is that both monetary and fiscal anchors are stronger than what investors believe.



Source: Bloomberg as of 22 November, 2021

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- **Summary**
  - Sound monetary and fiscal policy are necessary anchors to create conditions for sustainable economic growth.
  - Predictable reaction functions from central banks help economic agents make consumption and investment decisions. Lack of credibility in the execution of the CB mandate creates uncertainty.
  - For several years, many EM central banks have adhered to inflation targeting regimes, mostly with success. Monetary credibility has provided a strong anchor to these economies during crisis by targeting inflation dynamics while allowing for their currencies to free-float and adjust to the shocks.
  - Political changes and social demands could put further stress on fiscal accounts. Governments will be looking for resources to fund higher spending and debt burdens.
  - Current market levels in many of the Latam markets could be reflecting fears of a high probability of monetary de-anchoring in order to fund larger fiscal demands.
  - However, we believe that some of these risks could be overpriced. Even when presidential elections result in extreme candidates, the executives in question will have to deal with legislative bodies that in many cases are either extremely fragmented or are run by coalitions that do not respond directly to the ruling party. Examples include Mexico, after Lopez Obrador failed to reach legislative super majority. In Peru recently minted President Castillo does not only not have a majority but lawmakers have just filed a motion to impeach him. In Argentina the ruling Peronist-Kirchnerist coalition just lost Upper House majority for the first time in decades. Large shifts in economic policy might result much more difficult than investors fear, suggesting that abandoning monetary anchors due to weaker fiscal policy, while a potential risk bearing very close scrutiny, might not be such a fait accompli.

Ratings: Alpha and/or numeric symbols used to give indications of relative credit quality. These designations are published by the rating services.

Bond Credit Quality Ratings		**Rating Agencies**	
Credit Risk	**Moody's[1]**	**Standard & Poor's[2]**	**Fitch[2]**
Investment Grade			
Highest Quality	Aaa	AAA	AAA
High Quality (Very Strong)	Aa	AA	AA
Upper Medium Grade (Strong)	A	A	A
Medium Grade	Baa	BBB	BBB
Non-Investment Grade			
Low Medium Grade (Somewhat Speculative)	Ba	BB	BB
Low Grade (Speculative)	B	B	B
Poor Quality (May Default)	Caa	CCC	CCC
Most Speculative	Ca	CC	CC
No Interest Being Pain or Bankruptcy Petition Filed	C	D	C
In Default	C	D	D

Source: Citi Investment Management

[1] The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2 or 3 to show relative standing within the category.

[2] The ratings from AA to CC by Standard & Poor's and Fitch Ratings may be modified by the addition of a plus or minus sign to show relative standing within the category.

S&P: S&P Credit Quality Rating.